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PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

WATER DIVISION **RESOLUTION NO. W-4294a**
November 29, 2001

R E S O L U T I O N

(RES. W-4294), ALL WATER AND SEWER SERVICE UTILITIES. ORDER MODIFYING BALANCING ACCOUNT PROTECTION FOR OFFSETTABLE EXPENSES.

SUMMARY

This resolution addresses pending and anticipated requests of water and sewer utilities for offset rate relief and balancing account treatment for the offsettable expenses, purchased power, purchased water, and pump tax.

Several water utilities have filed advice letters seeking offset rate relief to compensate for recent increases in the costs of purchased power that were not anticipated in the utility districts' last general rate case (GRC). The Office of Ratepayer Advocates (ORA) protested such a request to increase the rates of 20 districts of California Water Service Company (CWS). ORA claims that: (1) offset rate increases should not be authorized for CWS districts because the utility is over earning (e.g. earning a rate of return (ROR) greater than that authorized in the company's last GRC); and (2) balancing account treatment should not be available to districts that are outside of their rate case cycle (e.g. districts that failed to apply for a GRC when, according to the Rate Case Plan (RCP) adopted in Commission Decision (D.) 90-08-045, or by other Commission order, they had an opportunity to do so).

Water Division staff correctly concludes that because staff processing of advice letter requests is confined, for the most part, to ministerial acts, the resolution process is not a proper venue to determine the substantive factual and policy issues raised by ORA's protest.[1] (See Sacramento Chamber of Commerce v. Stephens (1931) 212 Cal.607, 610; Webster v. Board of Education (1903) 140 Cal. 331, 331 Water Division recommends and the Commission adopts the initiation of an order instituting rulemaking

[1] Water Division staff has recommended approval of advice letter requests and the Commission has authorized related offset rate increases for smaller water utilities and districts of Class A water utilities that are not subject to the ORA protest – that is, those districts that are within their respective rate case cycle and are not over earning on an actual recorded basis. See for example, Resolutions W-4277, CWS, Bakersfield and Hermosa Redondo Districts; W-4283 Alco Water Service, Salinas District; W-4284 California-American Water Co., Monterey District; W-4288, Garrapata Water Co.; W-4289, Toro Water Service; W-4291, East Pasadena Water Co.; W-4292, Alco Water Service, Normco and Moss Landing Districts; W-4295, Del Oro Water Co., Magalia District.

(OIR) to review the issues presented by ORA's protest and related matters. In the interim Water Division recommends the Commission implement a specific course of action.

The Water Division staff concludes that: (1) the ORA protest raises issues that the Commission has not previously considered; (2) ORA's two-prong protest raises serious issues that warrant full consideration by the Commission; and (3) the Commission's consideration of ORA's recommendations should not be limited to one utility, but rather, should be considered on an industry-wide basis. We agree.

In this resolution, the Commission orders the Director of the Water Division to submit for our review an appropriate order instituting a rulemaking (OIR). We keep the current offset rate case/balancing account mechanism modified to permit recovery of offset revenue just enough to allow the utility to earn its last authorized return. Any excess expense in the balancing accounts should be transferred into a memorandum account for future recovery. We institute measures to preserve utility rights to recover under-collected, offsettable expenses incurred after this date subject to our determination, today or in the OIR proceeding, of what new procedures, if any, shall apply to recovery of those expenses. Finally, in the interim, we order that offset rate relief requested by advice letter shall be allowed only: (1) for Class A water utilities subject to the limit of their authorized rate of return on a weather normalized means test basis (pro-forma earnings test); and (2) for all other water and sewer utilities subject to actual recorded basis. We share ORA's concern about possible over earning in cases where a utility may obtain offset rate increases using obsolete adopted data that are older than three years. However, by limiting recovery of balances on the basis of the pro forma test (for Class A) and actual bases (for Class B, C, and D and sewer utilities) and for revenues not leading to excess earnings above authorized returns, we will mitigate that concern in the interim. We decline to adopt ORA's proposal to establish compliance with a three-year rate cycle as a condition to qualify for offset rate increase at this time.

To provide a meaningful context for this resolution, first we will address CWS's recent advice letter request for offset rate increases and the protests to that request. Thereafter, we will discuss the history of Commission-approved balancing accounts the rate case plan, general ratemaking and the application of the pro-forma earnings test in water utility cases.

CWS ADVICE LETTER AND PROTEST

Earlier this year, the Commission removed the previously established freeze on electricity rates and authorized rate increases for Pacific Gas and Electric Company (PG&E) and Southern California Edison Company (Edison) [2]. As a result of increased electricity rates authorized by D.01-01-08, D.01-04-005, and D.01-05-064, on

[2] As a result of these increases, approximately a dozen water companies have filed for offsets. Staff expects that the rest of the approximately 150 water and sewer systems the Commission regulates will also be requesting rate increases.

May 18, 2001, CWS filed Advice Letter 1493 requesting revision of their tariff schedules in 20 districts to provide an increase in revenues by $5,930,500 or 3.3% to offset their increases in purchased power expenses. The utility noticed customers of this request.

Pearl S. West, representing the Concerned Citizens Coalition of Stockton (CCC), addressed the Commission at its meeting of June 26, 2001. Although the CCC did not formally file a protest to CWS Advice Letter 1493, in her comments to the Commission, Ms. West specifically questioned the process that would be used to increase the rates of customers in CWS's Stockton District.

> "I understand that Cal Water is appealing for another rate increase predicated on an increase in electricity costs. As the owner of ten shares that should please me, but I need to report that my last quarter's dividend had already gone up. The average citizen, facing rising rates for all types of energy cannot pass these increases along to anyone and the questions are two. One, do upward rates ever recede? If so, under what circumstances? and Two, what role can the citizens of California expect the PUC to play in this drama?" (An Appeal to the California Public Utilities Commission, presented by Pearl S. West, Concerned Citizens Coalition of Stockton at 6/26/01 Commission meeting)

On July 6, 2001, ORA filed a late-filed protest to CWS Advice Letter 1493. ORA presented a recorded summary of earnings (12 months ending September 30, 2000) for the 20 CWS districts targeted for rate increases to demonstrate that the combined recorded return shows that CWS is over earning on a company-wide basis, that is, earning a return of 10.21% as compared to the last Commission-authorized return for the company of 8.79%. In addition to requesting that the Commission deny CWS districts offset rate increases, ORA requests that the Commission deny CWS districts, which are outside of their rate case cycles, the benefit of balancing account treatment. To achieve this result, ORA requests that the Commission Order provide the following:

> "Unless authorized by a further order of this Commission, California Water Service Company shall not book any under collections to its balancing accounts for its districts for which it could have but has elected not to file a general rate increase request." (ORA July 6, 2001 Protest, page 2.)

Using CWS's Stockton District to illustrate why ORA's two-prong request is justified, the Protest states:

> "The Stockton District of CWS is a typical example of the over earnings. The last time CWS filed a general rate increase request for its Stockton
>
> District was in 1995. Under the three year GRC cycle adopted by Decision 90-08-045, CWS could have filed another GRC request for this

> district any time after 1997. Apparently CWS has not filed a GRC for this district because it is already earning 11.10%. To now burden customers of the Stockton district (sic) with an additional rate increase is unwarranted."(Ibid. p.1)

CWS responded to ORA's protest by letter dated July 20, 2001. In its response CWS notes that ORA unfairly relies upon actual recorded earnings to show that the company is over-earning instead of using the weather adjusted, pro-forma earnings test. Because rates are set based on long-term average factors to determine water sales, in some years revenues will exceed estimates and in others revenues will be less than estimates. CWS notes that the recorded summary of earnings used by ORA include some of CWS's largest sales months in history and that since then water sales have significantly declined. CWS suggests that use of the weather-normalized means test (pro-forma earnings test) would present a more accurate picture of the company's earning status. Further, CWS acknowledges that in using the pro-forma earnings test, "the Commission has reduced or eliminated certain rate increases when Cal Water is earning over its authorized rate of return. However, the pro-forma earnings test has not been used to reduce or eliminate the recoverability of Cal Water's purchased power or purchased water costs." (CWS July 20, 2001 Response p.2.)

At Water Division staff's request, CWS attached to its July 20 response, a summary of earnings ending June 30, 2001, showing actual recorded earnings as well as calculations derived from the application of the weather-normalized, pro-forma earnings test. This summary shows that of the 20 districts targeted for rate increases, 15 districts exceed the authorized rate of return on an actual basis while only ten districts are over earning when the pro-forma earnings test is applied. Even the CWS June 2001 summary shows that the actual recorded company-wide return of 8.92% continues to exceed but, as CWS states, "is very close to Cal Water's authorized rate of return" of 8.79%. As for the illustrative Stockton District, the CWS June 2001 summary of earnings shows that Stockton continues to over-earn on an actual basis (11.08% as compared to ORA's September, 2000 summary of 11.10%). However, Stockton passes the pro-forma earnings test applied to the CWS June 2001 summary, apparently demonstrating that when one considers a weather-normalized earnings test, Stockton does not exceed the utility's last authorized rate of return.

CWS further objects to ORA's request that CWS be prevented from "booking into the balancing account any increase in costs in districts 'for which it could have but has elected not to file a general rate increase request'" as a change in policy that should be addressed in a generic proceeding. CWS points out that not filing for a GRC might be due to factors other than over-earning. CWS notes that "general rate increases are time consuming, costly and contentious" and that "Cal Water may choose not to file… because of community relations or other intangible factors not directly related to rate of return." When it doesn't file for a rate case, CWS claims that the utility has an incentive to operate more efficiently.

Noting that purchased power is the company's "third largest single expense", CWS claims that, if the Commission adopts ORA's recommendation to remove balancing account protection from districts that are outside their rate case cycles, CWS would have to file nine additional rate cases this year or risk the potential loss of between seven and nine million dollars related to the increased cost of purchased power and further risk a possible downgrade in CWS's credit rating[3].

On July 24, 2001, ORA replied to the CWS response. ORA states that the utility provides no documentary support for its suggestion that low rainfall and higher than normal temperatures caused "some of CWS's largest sales months in history" purportedly reflected in the September 2000 summary of earnings used by ORA. ORA also comments that although there are no existing restrictions that limit the use of balancing accounts, similarly, there are no existing requirements that mandate authorization of the rate increase that permits the cost pass-through of offsettable expenses and effectively activates the balancing account. ORA agrees with CWS that a utility's decision to delay filing a GRC may not always depend on utility over earning. However, ORA contends, "there is no justification to let utilities book amounts in balancing accounts beyond their rate cycle without any type of review, especially during times of over earnings." (ORA July 24, 2001 Reply page 2.)

BACKGROUND

The Edison Case – The History of Balancing Accounts

The steep increase in fuel prices in the early 1970s encouraged the development of rate-making adjustment mechanisms designed to protect utilities from the financial impact of unforeseen expenses, of a substantial nature, beyond the utilities' management or regulatory control. One such mechanism, the fuel cost adjustment clause, provided an expedited method for utilities to recover expenses related to the rapid changes in the cost of fossil fuel so that the utilities' ability to function would not be impaired, the need for frequent GRCs would be reduced and the utilities' position in the financial community would be enhanced (Re So Cal Edison Co. (1972) 73 Cal. P.U.C. 180, 190.).

By 1975, it became clear that the fuel clause was producing distorted results. Instead of simply reimbursing the utilities' actual fuel costs, on a dollar-for-dollar basis, the clause was producing an unintended windfall that bore no relation to actual utility expenditures. For example, during the period between May 1972 and December 1974, Southern California Edison Company (Edison) repeatedly invoked the clause, raised rates 12 times and by year end, 1974, it had accumulated an over collection of $122.5 million,

[3] CWS files its GRCs mid-year. We understand that after receiving ORA's Protest, in July 2001, CWS filed a Notice of Intent to seek GRC review for 17 of its districts, including the districts, outside their respective rate case cycles, that are referenced in CWS's July 20 response to ORA's Protest. Apparently eleven of the districts filed for in the NOI are outside of their respective rate case cycle, of which 10 are over earning on an actual recorded basis while four are over earning on a pro-forma means test basis.

representing 56% of the company's system wide net income. This net income was 47.8% higher than in the previous year even though 1974 sales actually were lower. The Commission modified the fuel clause to insure that utilities did not reap this unanticipated windfall at the expense of ratepayers. The modification was a balancing account entitled the energy cost adjustment clause (ECAC) (Re Investigation Into Fuel Cost Collection Practices of So. Cal. Edison Co. et. al. (1976) 79 Cal. P.U.C. 758 (D.85731) affirmed in Southern Cal. Edison Co. v. Public Utilities Com., (1978) 20 Cal.3d 813 [cited hereafter as the Edison Case]).

The California Supreme Court's decision in the Edison Case is particularly instructive for our purposes. The Court affirmed the Commission's decision establishing ECAC and explained how it effectively corrected the distorted results of the old fuel clause:

> "[T]he commission determined that the cost adjustment concept should be preserved but the clause should be modified to eliminate the defects revealed by experience. The principal such defect . . .was the provision authorizing Edison to base its calculations on a prediction of its fossil fuel needs for the 12-month period following each application for a billing adjustment, premised on the assumption that 'average' weather conditions would prevail throughout that time. The commission abandoned this procedure, and in lieu thereof adopted a clause which operates on a 'recorded data' basis, i.e., on the *actual* fuel expenses incurred by the utility during the period *preceding* its application for a billing adjustment (footnote omitted). The utility is now required to maintain a monthly 'balancing account,' into which it will enter the amount by which its actual energy cost for the month was greater or less than the revenue generated by the clause; and on each occasion hereafter that the clause is invoked, the billing factor will be adjusted so as to bring the balance of this account back to zero. By this device the possibility of large over-or undercollections accumulating in the future is eliminated. And because the commission expanded the clause to include all sources of purchased energy –e.g., nuclear and geothermal, in addition to fossil fuels, it renamed the device the 'energy cost adjustment clause.'" (footnote omitted) (Ibid. at 823, italics in original.)

In its appeal to the Supreme Court, Edison claimed that the company was entitled to keep the massive over collections generated by the old fuel clause because, during the relevant years, the utility's actual rate of return averaged less than the reasonable rate of return authorized by the Commission. Not so, said the Court.

> "First . . .Edison was not entitled to earn a profit on its expenses. Second, even its lawful profit was not guaranteed. A utility is entitled only to the *opportunity* to earn a reasonable return on its investment; the law does not insure that it will in fact earn the

> particular rate of return authorized by the Commission, or indeed that it will earn any net revenues." (Citations omitted) (Ibid. at 821, footnote 8, italics in the original.)

Edison argued that the rates generated by the old fuel clause were fair and reasonable when authorized. Therefore, the Commission's order requiring Edison to amortize the over collections, by 36 months of billing credit to customers, unlawfully subjected the utility to retroactive ratemaking. Again, the Court disagreed, as it carefully distinguished the Commission's development of "general rates," which are subject to the prohibition against retroactive ratemaking, from charges arising from the fuel clause, which were not the product of general ratemaking:

> "[T]he commission's decision to further adjust those rates so as to compensate for substantial past over collections may well be retroactive in effect, but it is not retroactive *ratemaking.*" (Ibid. at 830, italics in original)

> "Thus the commission was correct in formally finding that the rates fixed by operation of the fuel cost adjustment clause were not 'general rates' but 'extraordinary rates not created by or in a general rate proceeding'; and it was equally correct in concluding therefrom that 'The future reduction of fuel clause adjustment rates is not retroactive ratemaking' even though designed 'to reflect past over- or undercollections.'" (79 Cal. P.U.C. 758, 772, 773)" (Id. at 830, footnote 21.)

Finally, Edison argued that the Commission's abrupt change from the old fuel clause's average-year forecast method to the ECAC recorded method unreasonably disrupted the weather-normalized process by which the old clause, given enough time, would inexorably have balanced over and under collections resulting in net zero.

> "In its petition to this court Edison recognizes that the commission has traditionally made 'the valid historical assumption 'that over a period of years variations from historical average weather conditions will balance out.' And the same petition argues that if the weather cycle were allowed to run its course the present over collections would likewise be balanced out: abnormally wet and warm conditions created this 'temporary differential,' Edison asserts 'and it is only the commission's own decision to shift from an average-year forecast method to a recorded method that will prevent *the averaging out of the effect of the weather conditions on the revenue-expense differential in the long run.*'" (Ibid.) at 825, italics in the original.)

The Court notes that Edison, based on its own argument, had no long term expectation that the company would benefit financially from the fuel clause. Therefore, Edison should not be dismayed by the requirement that it return over collections to customers over a three-year period. That order, says the Court:

> "substitutes a definite credit period of three years in lieu of awaiting the natural completion of the current weather cycle, an event of uncertain date but statistically inevitable occurrence." (Ibid. at 826.)

Balancing Accounts for Water

In 1976, the Legislature enacted section 792.5 of the Public Utilities Code, which authorized expense offsets and required that utilities, upon receiving authorization to pass through the expense costs, maintain a reserve account reflecting the difference between actual costs incurred by the utility and the revenue collected through the offset rate increase. Over the years many water and sewer service utilities have filed for offsets for changes in expenses. Staff has reviewed the filings and generally created resolutions to approve those requests. Whenever such requests are granted, the resulting incremental revenues, and the incremental expense increases, must be booked to a balancing account in accordance with section 792.5.

The Commission first established rules for expense offsets for water utilities in 1977 and further, in 1978, provided rules for maintaining balancing accounts. The 1977 policy[4] described the advice letter offset program for purchased power, purchased water and pump taxes as "similar in concept to the electric Energy Cost Adjustment Clause (ECAC) or to Purchase Gas Adjustment (PGA) in that they allow a utility to recover cost-increases that are generally beyond their immediate control." This policy required that a rate of return, means test be applied to determine a utility's eligibility for the offset program:

> "[c] Traditional tests for offset proceedings be continued. *These require, that with the offset, the rate of return not exceed that last authorized by the Commission and the amount of the offset not exceed the revenue increase.* (sic.)" (June 21, 1977 Memorandum, Major Water Utilities Regulatory Policy, page. 1, italics added.)

On June 6, 1978, the Commission approved "Procedure for Maintenance of Balancing Accounts for Water Utilities." Those procedures did not include application of a means test for use of the offset/balancing account ratemaking treatment. The failure of the 1978 procedures to include a discussion of the rate of return means test is not explained. However, we do know that, for the past several years, the Commission staff has continued to employ the pro-forma earnings test to identify utility over earning. When such over earning is identified, often the utility's implementation of offset rate

[4] Memorandum to the Commission from B. A. Davis, Director, Operation Division, Subject: Major Water Utilities Regulatory Policy. Approved at the Commission Conference, June 28, 1977.

increases or recoveries of balancing account under collections are delayed (but not denied) until the earnings test shows that the utility is no longer over earning[5].

The 1978 balancing account policy, distributed to Class A and Class B water utilities, required that multi-district utilities maintain separate balancing accounts for each district and that each district or utility keep three separate balancing accounts for (1) water production cost offsets, including purchased water and purchased power; (2) ad valorem tax offsets; and (3) all other types of offsets. The balancing account balances were to be amortized at the time of a general rate proceeding. However, the availability of balancing accounts to record the over and under collection of offsettable expenses is continuous. After the balancing account is zeroed out, if increased costs are incurred for an offsettable expense, utilities can immediately begin to record under collections even if no new offset rate increase has been instituted.

> Maintenance of balancing accounts for any given item will start from the date the Commission first authorizes new rates passing through specific changes in cost. This restriction applies only to the first time the cost level for a particular item becomes the subject of an offset, all subsequent changes in cost of that item would be recorded in the balancing account as they occur." (Procedures for Maintenance of Balancing Accounts for Water Utilities (1978) Attachment B, page 1)

For the most part, the 1978 policies are in place today. This means that (consistent with the above quote) every single under collection of expenses, arising from recent electricity cost increases incurred by the water utilities, presently is being preserved in each utility district purchased power balancing account for future recovery. In other words, Water Division staff's inability to process some pending requests for immediate cost pass-through of new purchased power expenses does not constitute denial of those utilities' ability to recover those new expenses. Rather, said recoveries are simply delayed pending Commission resolution of the serious issues raised by ORA's protest.

Although the Water Division staff and the water utilities periodically review the procedures for offset rate increases and balancing account treatment, there have been only two significant occurrences since 1978 – a revised set of procedures issued in 1983, and the Commission's first consideration of balancing account treatment for water companies in a formal proceeding as discussed in D.94-06-033. As clarified in the 1983 procedures, balancing accounts for water record <u>only</u> the incremental change in cost increases incurred and revenues received since the utility's GRC or last offset rate increase. This is quite different from the ECAC, which incorporates all rates established to provide revenue to utilities for fuel costs, offset rate increases as well as rates established in the GRC. All of the revenue received for the fuel expenses are then

[5] Since the Commission decided in D.94-06-033 that, like energy balancing accounts, water utility balancing accounts should accrue interest, the delay in utility recovery of these expenses provides less benefit to ratepayers. For, when utility recovery eventually is authorized, ratepayers have to pay for the under collection and pay the interest on the under collection.

compared to all bills for fuel incurred to determine the over or under collection in the account. This difference in water balancing accounts appears to underscore the intended temporary nature of the account. It also emphasizes that, different from the ECAC, it is not employed to correct GRC estimate errors, only to provide a dollar for dollar protection to the utility against loss due to unanticipated increases in the offsettable expense. By not using the balancing account to true up the actual costs incurred and the projected expenses estimated in the GRC, the balancing accounts for water emphasize their reliance on the adopted quantities developed in the GRC.

The 1983 revised balancing account procedures addressed the use of GRC adopted quantities. It expressed concern about the use of fallible or unreliable adopted quantities that had been used to develop rates in an old GRC decision and further, it suggested that there is danger inherent in the unscrutinized use of those quantities to calculate contemporary rates:

> "Balancing accounts maintained beyond the latest test year will use the latest adopted quantities. Those cases, where the adopted quantities do not exist or where the latest decision is older than 5 years, will be handled on a case by case basis, by the Commission staff." (Attachment to May 31, 1983 letter to the water utility industry - "Procedures For Maintaining Balancing Accounts for Water Utilities", page 1.)

Adopted quantities are used to estimate the reasonable cost pass-through to be allowed in offset rate increases when a utility experiences new costs in offsettable expenses. In most cases, stale "adopted quantities" are unreliable because they do not accurately reflect or predict the relevant changes in a utility district's conditions since the GRC decision was issued (i.e., changes in the number of customers or changes in customers' use of water as reflected in the number of sales).

Use of unreliable "adopted quantities" in calculating the balancing account or the cost pass-through for offsettable expenses could provide utilities with undeserved income, or an unfair penalty if, as a result, utilities receive either more or less than the reasonable dollar-for-dollar reimbursement of expenses that the Commission intended that this rate adjustment mechanism provide. Of course it can be argued that the very operation of the balancing account will insure that any inequity, either for ratepayers or for the utility, will balance out over time. Even so, it is important that the offset rate increases be calculated carefully to not greatly disadvantage the ratepayers. The utility receives actual currency that it uses while the ratepayers are surrendering their funds in payment. If the ratepayers are charged too much, then the utility actually receives a short-term windfall (as in the Edison Case although on a much smaller scale). The fact that the utility has to pay interest on this over collection windfall is not the same disadvantage to the utility that a ratepayer paying interest on under collections is. Balancing account interest is low. Because the utility receives the offset rate increase, and therefore the money, this short-term windfall revenue, at low interest, is still a cheap source of money that the utility can use to its financial advantage.

Distorted balancing account results caused by use of stale adopted quantities would not be obvious, as it was in the Edison Case, where the unintended windfall was visible and could be verified by simple review of the mathematical calculations that produced the massive over collections in the balancing account. Rather, if use of stale adopted quantities distort balancing account results, as the 1983 balancing account policy apparently expected that it would, the problem can only be revealed by scrutiny of the adopted quantities and comparison of them to the identical component's current, actual quantities in a given utility district.

Since the rate cycle from one GRC application to a Commission decision on the next timely filed GRC application is more than three years, a utility would only need to forego filing a GRC one time to have adopted quantities based on estimates that are over five years old. Notwithstanding the 1983 policy proviso that staff members handle, on a case-by-case basis, the calculation of balancing accounts when the adopted quantities are more than five years old, this apparently does not happen. Staff has been unable to find one case in which the 1983 provision for case-by case processing has been implemented when adopted quantities are stale.[6]

In the early 1990s, the Commission opened an investigation into the financial and operational risks of regulated water utilities (Risk OII) that addressed issues relevant to Class A water utilities including balancing accounts. This is the only formal proceeding that has addressed balancing account treatment for water companies. The Commission decision, D.94-06-033, limited balancing account treatment to purchased water, purchased power and pump tax (groundwater extraction charges). Postage and property tax were removed from the list of offsettable expenses. The Commission also decided that water utilities' balancing accounts should earn interest, as did comparable accounts maintained by energy companies. In the Risk OII, the Commission considered but rejected a utility proposal that a program of complete revenue protection be developed using interest-bearing balancing accounts for all expenses. Although the Commission's decision did not authorize any additional balancing or memorandum[7] accounts, it did address the issue of booking costs to such accounts. It allowed utilities to file applications to book additional water quality costs to the Water Quality Memorandum Account provided the costs were:

> "…unforeseen and therefore were not included in the utility's last general rate case, that the costs will be incurred prior to the utility's next scheduled rate case (or otherwise cannot be estimated

[6] In fact, Water Division staff concludes that the 1983 provision could not legally be employed in advice letter requests, the utilities, preferred method of seeking offset rate increases. The development of new adopted quantities, different from those established by Commission decision, is a substantive, discretionary decision, well outside the ministerial tasks that the Commission can delegate to staff.

[7] A memorandum account is distinguishable from a balancing account. Memorandum accounts are initiated by a specific event that might require later rate relief and are established by Commission order. These accounts track targeted expenses , the recovery of which is subject to reasonableness review for both the type and the actual cost of the expense and requires Commission authorization.

> accurately for inclusion in a current rate case), and that the expenses are beyond the control of the utility." (D.94-06-033, p. 65)

The Risk OII addressed balancing account issues but the review was not comprehensive. For example, the impact of stale adopted quantities, from old GRC decisions, on the reasonableness of the cost pass-through in balancing account calculations was not considered; nor was the issue of utility over earning, raised by ORA's protest, addressed in the investigation.

<u>General Ratemaking, The Rate Case Plan and the Weather-Normalized Means (Pro Forma) Test for Water Utilities</u>

In 1990, the Commission adopted a rate case plan (RCP) for Class A water utilities in D.90-08-045.[8] Under the RCP, each utility is allocated a time for filing its GRC, generally, once every three years, either in January or July. The RCP for water utilities, like a similar plan for energy utilities, establishes a comprehensive schedule for the processing of rate cases. However, application of the RCPs for water and energy utilities differ in that energy utilities are required to file regularly for a GRC while no such requirement is imposed on water utilities. As noted by the Commission, the RCP for water utilities was intended to promote timely processing of GRCs, to enable the balancing of Commission workload and that of its staff over time, and "to enable a comprehensive Commission review of the rates and operations of all Class A water utilities by providing for the acceptance of general rate cases on a three-year cycle." (D.90-08-045 (1990), Appendix A, page 1.)

Although the RCP establishes a rate case cycle of three years (two test years and one attrition year), water utilities are not confined to that schedule. They may file a GRC application at any time, or not at all.

> "Class A water utilities may file general rate case applications at times other than those provided in the filing schedule determined by Branch, but such applications will not be processed under the time schedules of the RCP unless authorized by Branch. Individual elements of the time schedules may be observed for such applications as appropriate." (I<u>d</u>. at page 1.)

The Risk OII also addressed the filing of GRCs. The Division of Ratepayer Advocates (DRA), predecessor of today's Office of Ratepayer Advocates, proposed that the filing of GRCs every three years be mandatory. The Commission rejected DRA's mandatory three years GRC filing and kept the permissive process in place noting the Commission's staff can review utility earnings each quarter and recommend action in the event of abuse. (55 CPUC2d 188,189, D.94-06-033)

[8] Prior to the adoption of the RCP, water utilities could file GRC applications at will. In 1979, the Commission implemented the Regulatory Lag Plan an experimental program for scheduling and processing GRCs. The RCP replaced this experimental plan.

The application of a pro-forma earnings test[9] to determine a water utility's eligibility for GRC rate increases beyond the first test year has been a long-term practice.[10] On October 31, 1985 the Chief of the Water Utilities Branch, Wesley Franklin, sent a letter to all Class A, B and C water utilities promulgating "Guidelines for Normal Rate Making Adjustments in Connection with the Calculation of a Weather Normalized Pro-Forma Rate of Return on Recorded Operation for Water Utilities" (10/30/85). These guidelines were developed through a collaborative process between the staff of the Water Division and members of the water industry. The first sentence on the cover letter read:

> "Since 1982, Commission staff and water utility industry have met on several occasions to discuss the appropriate method for determining the "Pro-Forma" Rate of Return to be used in step rate filings, *offset filings,* and for other earnings reports to the Commission." (emphasis added).

The Risk OII proceeding described application of the pro-forma earnings test to determine eligibility for GRC second test year and attrition year increases:

> "If a utility is authorized to increase rates during the second test year or the attrition third year, the pro-forma test postpones or reduces an authorized increase if in fact the utility already is earning more than its authorized return. A DRA witness explained that if a utility is earning more than its rate case authorization, the pro-forma test does not require a refund. It simply prevents a full step-rate increase when the pro-forma earnings test shows that the

[9] The weather normalized, means test calculates the rate of return (ROR) by using (1) the revenues calculated by adding the actual commercial sales and actual number of residential customers times the already weather normalized number of sales per customer adopted in the last GRC minus (2) the expenses authorized in the last GRC adjusted by the actual number of customers and any approved offsets. These net revenues are divided by the actual rate base to determine the weather-normalized ROR

[10] Below is a sample of the language contained in the ordering paragraphs of GRC decisions describing how to apply the Pro-Forma Means test:

> "On or after November 6, 2000, CWS is authorized to file an advice letter, with appropriate work papers, requesting the step rate increase for the year 2001 included in Appendix B or to file a proportionately lesser increase for those rates in Appendix B for the Bear Gulch, East Los Angeles, and Visalia districts in the event that a district's rate of return on rate base, adjusted to reflect rates then in effect and normal ratemaking adjustments for the 12 months ended September 30, 2000, exceeds the lower of (a) the rate of return found reasonable by the Commission for CWS during the corresponding period in the then most recent rate decision or (b) 8.79%. This filing shall comply with GO 96-A. The requested step rates shall be reviewed by Water Division to determine their conformity with this order and shall go into effect upon Water Division's determination of conformity. Water Division shall inform the Commission if it finds that the proposed step rates are not in accord with this Decision or other Commission decisions. The effective date of the revised schedules shall be no earlier than January 1, 2001, or 30 days after filing, whichever is later. The revised schedules shall apply only to service rendered on or after their effective dates." (D.99-05-018, Ordering Paragraph 4)

> utility already is earning more than its authorized rate of return at the time the step-rate increase is to become effective." (D.94-06-033, p. 60)[11]

General ratemaking and the pro-forma earnings test reflect the reality that in California, weather conditions directly impact customer use of utility services. For example, in dry years, customers use more water than they do in wet years. As discussed extensively in the Edison Case (supra), it is generally recognized that California's varying weather cycles, over time, balance out. Accordingly, the concept of average year or weather normalized ratemaking is incorporated in the formula employed to develop a utility's revenue requirement from which the Commission derives general rates.

In the case of general ratemaking for water, the applicability of weather normalized estimates are incorporated in the development of general rates for the first and second test years and in the application of the pro forma earnings test to determine the utility's eligibility for second test year and attrition year rate increases. Because general ratemaking and the pro-forma test for earnings are both weather-normalized, the pro-forma test generally is perceived as a fairer earnings test than actual recorded earnings. That, however, may not always be the case.

Because general ratemaking is conducted prospectively, the utility's revenue requirement relies upon estimates of costs and capital investment expected to occur in the future years for which rates are being set. Estimates, no matter how carefully conceived, are not perfect predictors. While the pro-forma test captures the weather-normalized component of general ratemaking, it is not immune to erroneous estimates. For example, when adopted sales quantities are incorrect, the pro-forma test may not reveal that, but for the erroneous quantities, the utility would be shown as over earning, even on a pro-forma basis. Furthermore, when adopted quantities are stale products of an aged GRC, the pro-forma test's use of those quantities could render the pro-forma test an unreliable measure of utility district earnings.

DISCUSSION

In the instant case, ORA claims that water districts that elected to forgo filing a GRC application upon completion of its last authorized rate case cycle, especially those that

[11] The Decision also noted that the Means test was probably too complicated for Class B, C and D utilities to calculate and that actual return should be used as the Means test for those utilities.

are over-earning, should not be eligible for offset rate increases and balancing accounts. Class A water utilities are not required to file for a GRC on a regular basis.[12].

Offset rate increases and the attendant balancing account treatment evolved during the last 20 years through a collaborative process between the staff and the water industry in consideration of practical issues such as the Commission's resource availability and ability to complete GRCs and attrition for multiple districts on schedule, allowing some discretion to utilities to decide when to file GRCs. The offset rate case process/balancing accounts limit a utility's recovery of targeted expenses to the reasonable dollar-for-dollar incremental reimbursement of new expenses actually incurred by the utility. Therefore, this ratemaking mechanism does not, in and of itself, cause a utility to earn more than its authorized rate of return. The recovery of expenses provided by this ratemaking mechanism has operated until recently without regard to: (1) whether a utility is otherwise over earning; and (2) whether a utility has timely filed GRC application. These procedural issues are fundamental to ORA's protest. ORA suggests that the unrestricted availability of the offset rate increase/balancing account mechanism to water utilities has the unintended effect of perpetuating or promoting a utility's election to forgo the timely filing of a GRC.

Throughout the literature on balancing accounts, the stated purpose of providing this rate adjustment mechanism through offset rate increases/balancing accounts is to protect utilities from unforeseen expenses of a significant nature over which the utility has no control. According to ORA, eligibility for this offset rate increase would turn on whether the water company has followed the three-year rate case cycle. ORA's underlying concern is that actual sales could be higher than adopted (forecasted) levels and as a result the company's return would exceed the authorized return while the company may still be eligible for offset rate increases. And that the further away from the adopted quantities, the greater the risk of customer overpaying. ORA's proposal would attempt to fix the problem by establishing compliance with the three-year rate cycle as a first test for offset rate increase eligibility.

ORA does not explicitly request that water companies be required to regularly file GRCs as it did in the Risk OII. Rather, ORA believe that when a Class A district fails to do so, it should have to assume the risk of incurring otherwise offsettable expenses. However, by tying the offset rate case process to the GRC cycle, ORA's proposal would, in effect, act as an enforcement of a three-year rate cycle filing that the Commission in more than one occasion has declined to mandate. Moreover, it presumably would introduce additional financial risk to the water company that the water companies mention the Commission should consider if it decides to implement ORA's proposal.

[12] One Class A water utility waited over 15 years before it filed a GRC application. Between rate cases, the financial integrity of the utility did not suffer. Despite an antiquated rate structure, the utility was able to maintain financially viability, including a substantial return on its investments because it experienced significant customer growth and was able to offset increased costs in purchased power, purchased water and pump tax by using the advice letter process to obtain offset rate increases.

We find this Resolution process ill-equipped to address the numerous issues ORA's three-year rate case cycle proposal raises. Establishing such a requirement must consider all attendant issues that ORA and the water companies raise such as the impact of a mandatory three-year rate case cycle on earnings and rate of return policy, resource management issues, and on regulatory lag and risk and return issues. We shall consider these and other relevant issues in the OIR. In the mean time, we decline to adopt a three-year rate cycle requirement as a condition to qualify a water company for offset rate increases and balancing account treatment. In adopting the rate case plan (RCP), the Commission made explicit allowance that water companies are free to file GRCs "at times other than provided in the staggered filing adopted by Branch." (37 CPUC2d, 182) That requirement will stay in place until changed by the Commission. By declining ORA's proposal at this time, we are not dismissing that ORA's concerns about the "stale adopted" data and excess recovery of returns by Class water companies are without merit. In fact, we share ORA's misgivings that the existing offset rate increase/balancing account mechanisms lack the necessary checks and balances to protect ratepayer interest and may cause excessive earnings above authorized levels. However, a careful and thorough review of the rate adjustment mechanism and attendant risk and return issues is necessary to reach a sustainable policy that protects ratepayers interest while permitting the water companies an opportunity to earn a reasonable rate of return.

ORA's other proposal would limit a utility's recovery subject to a earnings test. ORA's protest suggests that the Commission's failure to consider the interaction of an offset rate increase and the utility district's earnings status might promote the approval of unjust and unreasonable rates, especially when the utility is over earning. CWS points out that the Commission has not used earnings tests to eliminate the utility's eligibility for balancing account recovery.

This Commission has not previously considered the dispute between ORA and CWS over use of the actual recorded earnings as opposed to the pro-forma earnings. The issue of the reliability of stale adopted quantities from an aged GRC has relevance to the application of the pro-forma test as well as to the calculation of the cost pass-through allowed in an offset rate increases. On the other hand, use of the pro-forma earnings test when a utility district is in its rate case cycle does not suffer from the problem of stale adopted quantities. For not only are the adopted quantities fresh but, as CWS points out, in the pro-forma test, increased water sales (a probable reason of over-earning) are estimated using a long-term average process[13]. Using the pro-forma test, the utility will be labeled as over-earning only if customer growth is greater than anticipated, rate base growth is less, or due to changed market forces, the utility's most recent authorized rate of return is less than that authorized at the time of the district's

[13] Using a linear regression program, the actual sales for a particular district are regressed against explanatory variables, such as temperature and rainfall. This results in a mathematical model of that district's usage. To estimate future sales a long-term (30-year) average of temperature and rainfall (for example) are inserted into the model, resulting in the estimate of average (long-term) future sales per customer. Thus, on average, actual sales per customer will be higher than estimated about one-half of the time. (This assumes that there is no underlying influence resulting in continually increasing water sales per customer, such as increased density of swimming polls with time in a district. If this is the case, the above process is inadequate.)

GRC. The Commission has not previously used actual earnings as a standard for denial of a rate increase for Class A water companies. ORA's protest asserts the validity of using actual earnings as the proper indices for determining utility eligibility for the extraordinary rate increases authorized for offsettable expenses. In this argument, ORA punctuates the fact that the utility receives actual earnings – actual dollars – not pro-forma dollars. As is apparent from the discussion of the CWS pro-forma and actual earnings in the Stockton District, the pro-forma earnings is often less than the actual earnings received. As noted on page 4 of this resolution, Stockton passes the pro-forma test indicating that, hypothetically, it is earning less than the authorized rate of return of 8.79% even though the district, in fact, was earning 11.08%, more than 200 basis points greater than the authorized return.

We will adopt on an interim basis a pro-form test to determine whether and to what extent a water company should be authorized to recover offset rate increases. For Class A water companies, as it did in Resolution W-4210 (July 20, 2000) for California Water Service Company's Livermore District, the Water Division should review offset rate increase requests by applying a pro forma earnings test to ensure that additional revenues do not lead to utility over earning above the last authorized rate of return for that water company or district.

For purposes of the interim measures we adopt today, we make some distinction between the large water utilities (Class A) and smaller water utilities (Class B, C, and D) as far as application of earnings test is concerned. Traditionally, we have treated smaller water companies under more liberal regulatory or different rules than those applicable to large utilities primarily because of the various peculiar problems smaller water utilities face in their operations and financial circumstances. In the upcoming OIR we intend to look into issues that could further lead to separate treatment of the two groups based on the evidence and record to be developed. In the mean time, for Class A utilities, the earnings test will be weather normalized pro forma test. For Class B, C, and D and sewer utilities, the test will be based on actual recorded figures as in current practice. We decline to require Class A, B, C and D utilities to file GRCs every three years in order to qualify for offset rate increases as ORA urges us to do.

We shall revisit these and all other attendant issues within the OIR Water Division recommends we initiate to consider a permanent policy on offset rate increases and balancing accounts for Class A, B, C, and D water companies. The interim measures we adopt in this Resolution will be applied prospectively. Current balances in balancing accounts that have accumulated until the effective date of this resolution shall be disposed of in the manner described below.

RECOMMENDATIONS

The Water Division (staff) has evaluated the protest, response and comment and reviewed the history of offsets and balancing accounts. After consideration, staff recommends that the Commission Order the Director of the Water Division to prepare for Commission review, an appropriate Order Instituting Rulemaking (OIR) to evaluate existing practices and policies and determine whether new procedures or policies for processing offset rate increases and balancing accounts should be made and further, to determine whether offsettable expenses and balancing account guidelines should be made permanent, unless changed by later order of the Commission.

Pending further Commission determinations in the context of the OIR:

1) All water companies with existing balancing accounts should, effective the date of this resolution, suspend those balancing accounts and start a new and separate balancing-type memorandum account, (or in the alternative, a memorandum account as specifically ordered below), for each offsettable expense of purchased water, purchased power or pump tax. This will provide the Commission and the utility with a convenient, clear demarcation between the accounting for offsettable expenses from the date that the utilities have notice that the Commission is considering changing rules and policies for allowing offset increases and balancing account processing.
2) The processing of existing balances in balancing accounts for Class A water companies should be determined subject to a weather normalized means (pro forma) earnings test to grant no more additional revenue than that necessary to meet the last authorized rate of return for the water company or the district.
3) Water Division staff shall continue to approve advice letter offset rate increase requests by Class B, C, and D and sewer utilities for current and prospective balances in balancing accounts subject to actual earnings test based on the latest year recorded figures.
4) Prospectively, utilities should establish and maintain a balancing-type memorandum account, newly established after the date of this resolution. For expenses accumulated in these accounts, Water Division staff should continue to recommend approval of advice letter offset requests by Class A, B, C, and D utilities only for an additional revenue amount that will lead to no more than the last authorized return.
5) To preserve the rights of utilities to recover uncollected expenses, consistent with established Commission rules, the utility or district should establish a memorandum account to track the uncollected offsettable expense increases. Upon commencement of receiving the offset revenue, the utility or district should convert the memorandum account to a balancing-type memorandum account where increased expenses and revenues will be tracked.
6) Consistent with the existing practices and rules, Water Division staff should process advice letter requests by preparing an authorizing resolution submitted for Commission consideration.

INITIAL COMMENTS

On September 25, 2001, Water Division recommended resolution was mailed or hand delivered to all regulated water and sewer system utilities, ORA, and to the Concerned Citizens Coalition of Stockton for comment. The Water Division (WD) received 9 sets of comments on the proposed resolution W-4294. Comments were received on or before October 15, 2001 from the following Class A water utilities: CWS, San Jose Water Company, Park Water Company (Park), California-American Water Company and Citizens Utilities Company (CalAm), San Gabriel Valley Water Company (San Gabriel), and Suburban Water Systems, from ORA and the California Water Association (CWA). Most comments urged the Commission to reject this resolution and to adopt a more moderate approach beneficial to the utilities. CWA, San Gabriel and Park urged that no change to the existing offset increase/balancing account process be implemented until after the OIR is completed. ORA timely filed comments as well as filed reply comments on October 19, 2001. ORA is the only party that supported the resolution as written, and even ORA asked that it be modified to not delegate advice letter approval to the staff but rather that Commission approval for all offset increases and balancing account recoveries be required. That provision is implemented. All comments were considered and this resolution was modified to include more explicit, clarifying language. Most of the comments would more properly be addressed in the OIR and will be included in the issues that staff raises in the OIR.

FINDINGS AND CONCLUSIONS

The Commission finds, after investigation by the Water Division, that the procedures authorized herein are justified and that they are designed to protect the rights of all parties relevant to the issues raised. Further, procedures established for the development of offset rate increases and balancing account processing are designed to promote just and reasonable rates and equitable treatment for ratepayers and utilities.

THEREFORE IT IS ORDERED that:

1. The Director of the Water Division shall prepare for Commission review, an appropriate Order Instituting Rulemaking (OIR) to evaluate existing practices and policies and determine whether new procedures or policies for processing offset rate increases and balancing accounts should be made and further, to determine whether offsettable expenses and balancing account guidelines should be made permanent, unless changed by later order of the Commission.
2. All water companies with existing balancing accounts shall, effective the date of this resolution, suspend those balancing accounts and start a new and separate balancing-type memorandum account, (or in the alternative, a memorandum account as specifically ordered below), for each offsettable expense of purchased water, purchased power or pump tax.

3. Water Division staff shall continue to approve advice letter offset rate increase requests by Class B, C, and D and sewer utilities for current and prospective balances in balancing accounts subject to actual earnings test based on the latest year recorded figures.
4. The processing of existing balances in balancing accounts for Class A water companies should be determined subject to a weather normalized means (pro forma) earnings test to grant no more additional revenue than that necessary to meet the last authorized rate of return for the water company or the district.
5. Prospectively, utilities should establish and maintain a balancing-type memorandum account, newly established after the date of this resolution. For expenses accumulated in these accounts, Water Division staff should continue to recommend approval of advice letter offset requests by Class A, B, C, and D utilities only for an additional revenue amount that will lead to no more than the last authorized return.
6. To preserve the rights of utilities to recover uncollected expenses, consistent with established Commission rules, the utility or district should establish a memorandum account to track the uncollected offsettable expense increases. Upon commencement of receiving the offset revenue, the utility or district should convert the memorandum account to a balancing-type memorandum account where increased expenses and revenues will be tracked.
7. Consistent with the existing practices and rules, Water Division staff should process advice letter requests by preparing an authorizing resolution submitted for Commission consideration.

I certify that the foregoing resolution was duly introduced passed, and adopted at a conference of the Public Utilities Commission of the State of California held on November 29, 2001; the following Commissioners voting favorably thereon:

WESLEY M. FRANKLIN
Executive Director